LEARNING OBJECTIVES

1. Contrast the characteristics of IRAs with qualified plans.*
2. Explain the impact of compounding on the ending value of an IRA account after years of continuous funding.
3. Describe the funding limits for traditional and Roth IRAs.*
4. Describe the impact of converting funds in a traditional IRA or qualified plan to a Roth IRA.*
5. Determine the deductibility of contributions to a traditional IRA including taking into consideration the characterization of active participant status.*
6. Calculate the penalties associated with overfunding traditional and Roth IRAs.*
7. Understand the importance of Form 8606.
8. Describe the nature of the taxation of distributions from traditional and Roth IRAs.*
9. Understand the exceptions to the 10 percent early withdrawal penalty that apply to IRAs.*
10. Explain the types of investments that are permitted to be held within an IRA.*
11. Describe the advantages and rules associated with Simplified Employee Pensions (SEPs).*

** Ties to CFP Certification Learning Objectives*

INTRODUCTION

IRAs, SEPs, SARSEPs, SIMPLEs, and tax sheltered annuities (403(b) plans) are not qualified plans, do not meet the requirements under IRC §401(a), and are not entitled to all of the same benefits as qualified plans. They are referred to as "other tax-advantaged plans" to indicate that, while not qualified plans, they have many of the same benefits and features as qualified plans. While all of these plans have many of the benefits of qualified plans, they also have certain advantages over qualified plans. Similar to qualified plans, tax-advantaged plans are all tax deferred, meaning that earnings within the trust or plan are not taxed until a distribution occurs. In addition, all of these tax-advantaged plans provide for sheltering of current income from taxation.

However, IRAs, SEPs, and SIMPLEs have many key differences from qualified plans. First, IRAs, SEPs, and SIMPLEs are not subject to the same federal reporting requirements as qualified plans. Second, lump-sum distribution options such as NUA, pre-74 capital gain treatment, and 10-year forward averaging are not permitted for distributions from IRAs, SEPs, SIMPLEs, or 403(b) plans. Third, these plans also do not have the same non-alienation of benefits protection found under ERISA. Fourth, these plans, with the exception of the 403(b) plan, are not permitted to offer loans to participants. Fifth, whereas qualified plans typically have specific vesting schedules for contributions made by the employer on behalf of the employee, other tax-advantaged plans always provide for 100 percent vesting, with the exception of some employer contributions to 403(b) plans.

This chapter discusses the rules surrounding Traditional IRAs, IRA annuities, Roth IRAs, SEPs, and SARSEPs. SIMPLE plans, 403(b) plans, and 457 plans are discussed in the following chapter.

Exhibit 9.1 | Characteristics of Qualified Plans and Other Tax-Exempt Plans

Characteristic	Qualified Plans	IRAs	SEP IRAs	SIMPLE IRAs**	403(b) Plans
Provides for tax deferral for deposits and savings	✓	✓	✓	✓	✓
Provides shelter for current income	✓	✓	✓	✓	✓
Annual reporting – Form 5500	✓	✗	✗	✗	Maybe***
Vesting required	✓	✗	✗	✗	Maybe
Loans are permitted	✓	✗	✗	✗	✓
Protection under ERISA	✓	✗****	✗****	✗****	Maybe*
10-year averaging permitted	✓	✗	✗	✗	✗
Pre-74 capital gain treatment	✓	✗	✗	✗	✗
Distributions eligible for NUA	✓	✗	✗	✗	✗

✓ *YES* ✗ *NO*

**Many 403(b) plans provide for ERISA protection; however, some do not.*
*** There are very few, if any, SIMPLE 401(k)s.*
****Employer maintained 403(b) plans must file Form 5500.*
***** Although federal bankruptcy protection is available under the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005.*

KNOW THE NUMBERS (2021)

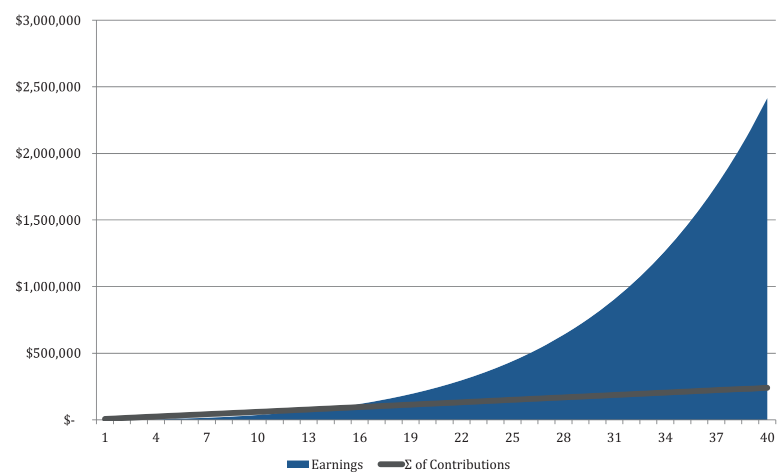
	Traditional IRA	Roth IRA	SEP	SARSEP
Contribution Limit	$6,000	$6,000	25% or $58,000	$19,500
Catch-Up (Over age 50)	$1,000	$1,000	N/A	$6,500
Contribution Phaseout 2021	N/A	Single: $125,000 – $140,000 MFJ: $198,000 – $208,000 MFS: $0,000 – $10,000	N/A	N/A
Deduction Phaseouts 2021	Not an Active Participant: No Limit Active Participant: Single: $66,000 – $76,000 MFJ: $105,000 – $125,000 One Spouse is an Active Participant: $198,000 – $208,000	N/A	N/A	N/A
Provide to Employee With	N/A	N/A	Compensation > $650	N/A

INDIVIDUAL RETIREMENT ACCOUNT

The Individual Retirement Account (IRA) has been available since 1974.[1] The amount that could be contributed on a tax-deferred basis per person per year was once limited to $1,500, but that has now been increased to $6,000 for 2021 with an additional deferral of $1,000 for 2021 for persons age 50 or older. The rules regarding deductibility have also changed as will be explained in this chapter. The IRA has great potential as an accumulation device for retirement when started early and funded annually. Consider an individual who makes annual year-end deposits of $6,000 in a mutual fund earning a 10 percent return each year for 40 years (age 25-65). The future accumulated balance of the account at age 65 is $2,655,555 even though the individual only deposited a total of $240,000. The compound growth potential of such accounts often makes the tax deductibility of the contribution a less significant issue than the accumulation, as illustrated in the graph below.

Key Concepts

1. What is the limit on contributions to an IRA for 2021?
2. What is considered earned income for purposes of IRA contributions?



There are two general types of **individual retirement accounts** (IRAs) under present law: traditional IRAs, to which both deductible and nondeductible contributions may be made, and Roth IRAs, to which only nondeductible contributions may be made.[2] Many of the rules relating to traditional IRAs and Roth IRAs are the same and will be discussed together under traditional IRAs. The differences between the types of IRAs are discussed later in this chapter.

Traditional IRAs

Traditional IRAs have been available for many years and as the limits on both contributions and deductions have increased, these retirement vehicles remain an important part of retirement planning for individuals. IRAs take one of two forms, an individual retirement account or an **individual retirement annuity**. An IRA account can hold a wide variety of investments and can be held by a wide variety of **custodians** (e.g., brokerage, bank, mutual fund, etc.). An IRA annuity is usually held by an insurance

1. IRC §408.
2. This chapter does not consider Coverdell Education Savings Accounts (formerly known as Education IRAs).

company as custodian. As a result of the increased contribution limits established under EGTRRA 2001, and made permanent by PPA 2006, IRAs have become a more significant part of planning for retirement.

Exhibit 9.2 | History of IRAs[3]

Individual retirement accounts were introduced in 1974 with the enactment of the Employee Retirement Income Security Act (ERISA). As the Congress originally conceived the accounts, participants could contribute up to $1,500 a year and reduce their taxable income by the amount of their contributions. Initially, ERISA restricted IRAs to workers who were not covered by a qualified employment-based retirement plan. But the 1981 Economic Recovery Tax Act allowed all taxpayers under the age of 70½ to contribute to an IRA, regardless of their coverage under a qualified plan. It also raised the maximum annual contribution to $2,000 and allowed participants to contribute $250 on behalf of a nonworking spouse. The Tax Reform Act of 1986 reversed the trend toward expanded participation by phasing out the deduction for IRA contributions among higher-earning workers who are covered by an employment-based retirement plan themselves or who have a covered spouse.

In the 1990s, the Congress raised some of the limits it had previously placed on IRA contributions and also created the Roth IRA - a new type of account that features nondeductible contributions and tax-exempt withdrawals. The Small Business Job Protection Act of 1996 raised the limit on contributions on behalf of nonworking spouses from $250 to $2,000. Further changes came in the Taxpayer Relief Act of 1997. In addition to creating Roth IRAs, it increased the income threshold above which deductible contributions are phased out and distinguished between taxpayers who are covered by an employment-based plan and those who are not but whose spouses are covered. The income thresholds for the latter category of taxpayers are now higher than those for the former, which allows more people who are not covered by an employer's retirement plan to make tax-deductible contributions.

Additional changes to IRAs resulted from the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). The law raised the limit on contributions beginning in 2002 and allowed "catch-up" contributions by people ages 50 and above. It also provided a nonrefundable credit for certain contributions to an IRA or a 401(k)-type plan.

The Setting Every Community Up for Retirement Enhancement Act of 2019 (SECURE) further expanded the ability to contribute to IRAs by removing the age cap (formerly 70½) for contributions to traditional IRAs and increasing the mandatory distribution starting age from 70½ to 72.

Contribution Limits

Prior to EGTRRA 2001, contributions to a traditional IRA were limited each year to the lesser of $2,000 or earned income. EGTRRA 2001, however, increased the maximum contribution over several years. As a result, individuals could contribute a maximum of $3,000 or earned income in 2004, $4,000 or earned income in 2005-2007, and $5,000 or earned income in 2008. Beginning in 2009, the $5,000 contribution limit is subject to adjustment for inflation (the contribution limit is $6,000 for 2021).[4] In addition, individuals who have attained the age of 50 before the end of the current taxable year are also eligible to

3. http://www.cbo.gov/OnlineTaxGuide/Page_2A.htm. Note: Link is no longer active. SECURE Act information added by Money Education.
4. IRC §219(b)(5)(D).

make catch-up contributions, thereby further increasing the annual IRA contribution limit. These contribution limits, which are combined for both traditional and Roth IRAs, are summarized in the following chart. Note that the catch-up contribution is not adjusted for inflation.

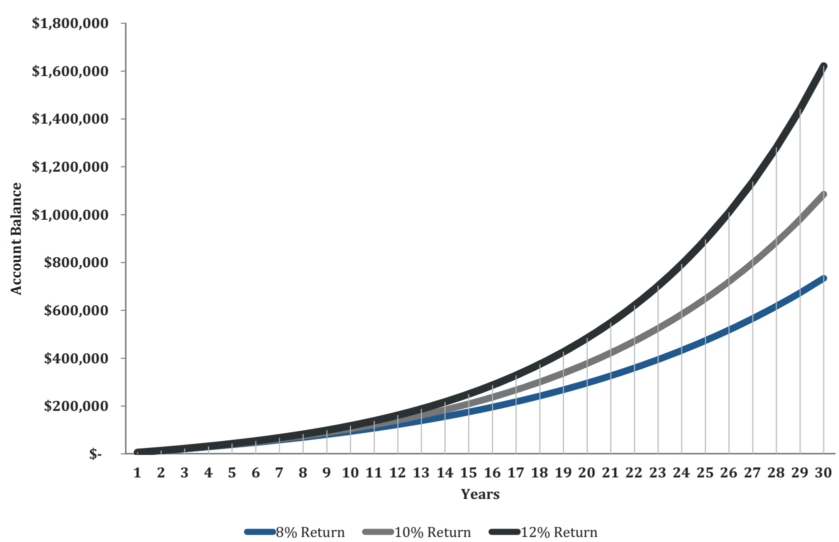
Exhibit 9.3 | Contribution Limit for IRAs (Traditional & Roth)

Year	Annual Limit	Catch-Up Limit (for those over age 50)	Maximum Contribution
2021	$6,000	$1,000	$7,000

Example 9.1

The following chart and graph depict the accumulation over time in an IRA assuming a $6,000 contribution was made to the account at the beginning of each year and without considering the availability of the catch-up contribution and the increase in the limits. Notice that after ten years, $60,000 of deposits have accumulated to $105,187 assuming a 10 percent rate of return. After thirty years, $1,085,661 has accumulated assuming a 10 percent rate of return.

Years	Amount Deposited	8% Return	10% Return	12% Return
1-5	$30,000	$38,016	$40,294	$42,691
1-10	$60,000	$93,873	$105,187	$117,927
1-15	$90,000	$175,946	$209,698	$250,520
1-20	$120,000	$296,538	$378,015	$484,192
1-25	$150,000	$473,726	$649,091	$896,004
1-30	$180,000	$734,075	$1,085,661	$1,621,756



Example 9.2

A straight deposit equal to $6,000 per year assuming contributions are made at the end of each year at various earning rates for 30 and 40 years are:

Years (N)	Rate (i)	Annual PMT	Amount Deposited	FV
30	8%	$6,000	$180,000	$679,699.27
30	10%	$6,000	$180,000	$986,964.14
30	12%	$6,000	$180,000	$1,447,996.11
40	8%	$6,000	$240,000	$1,554,339.11
40	10%	$6,000	$240,000	$2,655,555.33
40	12%	$6,000	$240,000	$4,602,548.52

Earned Income - Individual IRA

The annual contributions to an IRA are limited to the lesser of an individual's earned income or the annual limit in effect. **Earned income** includes any type of compensation where the individual has performed some level of services for an employer or is considered self-employed. Compensation includes earnings for W-2 employees or those individuals who are self-employed, whether they operate a sole proprietorship, partnership, or an LLC taxed as a sole proprietorship or partnership.

Earned income may also include alimony received by the taxpayer. For federal income tax purposes, **alimony** is deductible by the payor and is includible as earned income by the recipient if it pertains to a divorce agreement signed before 2019. Alimony attributable to divorce agreements signed after 2018 is not included in income and thus not earned income.[5] For tax years beginning after December 31, 2019, the SECURE Act of 2019 expands the definition of earned income for IRA contributions to include any amount included in gross income when paid to an individual in the pursuit of graduate or postdoctoral study (e.g., taxable fellowship or stipend payments). **Exhibit 9.4** provides a list of earned income and a separate list of what is not earned income.

Example 9.3

In Letter Ruling 9202003, the IRS ruled that hogs transferred from a husband to his wife (a bona fide employee) did in fact constitute compensation (earned income) and could be used as the basis for contributions to an IRA.

Earned Income - Spousal IRA

Individuals who do not have any earned income may still be eligible to establish an IRA if their spouse has sufficient earned income. An IRA for a spouse who has no earned income is generally referred to as a spousal IRA and can be established provided the other spouse has sufficient earned income. The necessary level of earned income is equal to the total amount that is to be contributed to both spouses' IRAs. **Spousal IRAs** can be established up to the contribution limit for the year in question ($6,000 for 2021). The catch-up contribution is also available for those individuals age 50 and over.

5. These rules were modified by the TCJA 2017.